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Some Considerations for a South Dakota State Income Tax

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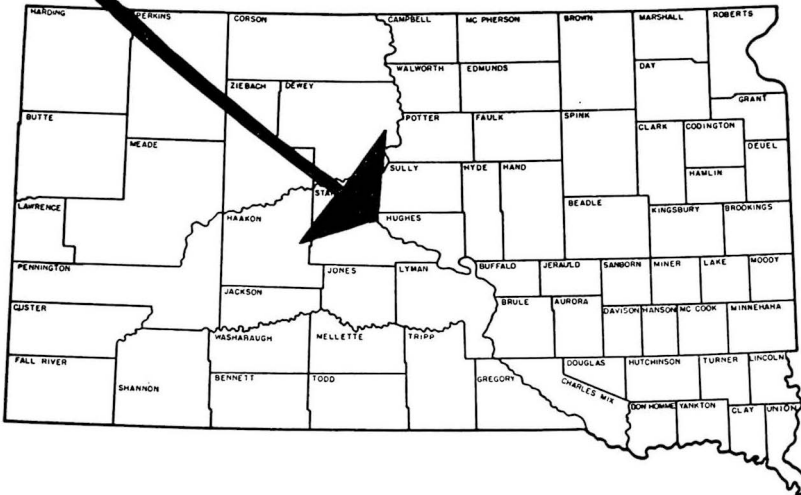
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some considerations for a South Dakota

STATE INCOME TAX



ECONOMICS DEPARTMENT
AGRICULTURAL EXPERIMENT STATION
SOUTH DAKOTA STATE COLLEGE, BROOKINGS

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Some Considerations for a South Dakota

STATE INCOME TAX

JOHN THOMPSON¹

Taxpayers in South Dakota can soon be expected to have to face ways more revenue can be most adequately and equitably raised to give them the services they will probably want or need.

The need for additional revenue seems eminent because of the anticipated increases in (1) educational expenditures, (2) expenditures for highways, and (3) expenditures for public welfare. This additional revenue will be required, assuming that the quality of the services is not impaired and assuming that no substantial savings will occur in efficiencies in meeting such needs. The threat of further inflation also suggests additional costs.

The additional revenue that will be required for education, for example, is almost a certainty when one considers a single factor—the youth who will be in the age group to be educated. Many of those who will be attending school in the next 10 to 12 years are already born, so such estimates, at least for secondary and higher education, have a high degree of accuracy. It is conservatively estimated that enrollment in colleges and universities in South Dakota will approximately double for the period 1957 to 1970.² The Bureau of Census estimates

that population from 5 to 19 years of age (primary and secondary school age) on the national level will increase by almost 40% for the same period.³ The population for a similar age group in South Dakota will probably follow a comparable pattern, in which case greater revenue requirements can be expected.

Where should additional revenue be obtained to provide the type of services which will be required? One possibility is to have a state income tax. Some 31 states and 420 or more cities and other local governments now have some form of individual income tax. The six states that put this tax to the greatest use derive from 27 to 42% of their revenue from it.⁴

This circular presents some advantages and disadvantages of the

¹Associate Economist, South Dakota Agricultural Experiment Station.

²Estimates presented at the Governor's Conference on Education Beyond the High School, Huron, South Dakota, April 15, 1958.

³Bureau of Census, *Current Population Reports Population Estimates* "Illustrative Projections of the Population of the United States, by Age and Sex—1960 to 1980." Series p-25, No. 187, Table A-5.

⁴Committee on Public Finance, *Public Finance*, Pitman Publishing Corporation, New York Copyright, 1959, pages 351-352.

individual income tax. It also indicates what such a tax might be expected to yield under different alternatives of operation. Statistics are included to give an indication of the cost of administering an income tax.

It must be pointed out that a circular of this size cannot include a detailed analysis of all aspects of the income tax. For that reason an effort was made to select those aspects which seemed to be most important in terms of the economy of South Dakota and in terms of the total tax system in the state.

Some Advantages of a State Income Tax

One of the main reasons many feel the income tax should be considered as a possible source for more revenue is that it achieves what many people consider the most equitable kind of tax treatment. Few will argue that a tax should not be equitable. Equity is defined as equal treatment for persons in like circumstances. In theory, and to a large extent in practice, the income tax falls with equal weight (equal tax rates) on those with equal net incomes, exemptions, and deductions.

Equitable tax payments are thought by many taxpayers to be payments that vary in accordance with ability to pay, and the amount of net income that is received is one indication of ability to pay. This view is also held by most of the authorities in the field of public finance. Professor Groves, of the University of Wisconsin, an authority in this field says:

It is a widely accepted proposition that on theoretical grounds alone the income tax should be the most important tax in our tax system. It represents the most rational means of taxation in a modern capitalistic state.—There was a time when most people thought equity in taxation required distribution of taxes according to benefits received from the government. More and more people have by now come to regard ability to pay as the proper standard of equity in taxation. These people usually regard income as by all odds the best single measure of ability to pay.⁵

For those who view an equitable tax as one that is based primarily on benefits received, the progressive income tax is apt to seem unfair. There are many ways of measuring benefits, however. Whether the high income recipients benefit more or less than the lower income groups from tax sponsored services and investments is a real question.

To many people, not only is the income tax symbolic of the most equitable type of tax, the use of the income tax is apt to make the total tax system seem more equitable to them. People who believe that ability to pay is the best basis for taxation would probably urge that an income tax be employed in lieu of increases in property taxation to achieve more equity in the total tax system. A person's property holdings are no longer a very good indication of his ability to pay taxes, because of the wide variation among different occupations in value of property needed to make an adequate net profit.

⁵Groves, Harold M., *Financing Government*, 3rd Edition. (1950) Henry Holt and Company, New York, pages 216-217.

The property tax does not meet the usual definition of equity when viewed broadly. While there may be fairly equitable treatment of property owners within a school district, in most cases there is not equitable treatment of property owners between districts. Property owners with practically identical properties do not get equal treatment even if assessments are uniform between districts. Mill rates vary with need, and there are levy limitations on certain types of property for certain purposes. This is not to suggest that mill rates should not vary from district to district or by type of property. It is only that the property tax does not achieve, in the broad sense, the same degree of equity as is achieved by the income tax.

In this regard, it might be that a principal cause for our delay in school reorganization is the fear that such action would cause more **inequity** in sharing assumed reorganization costs because of our heavy reliance on property taxes for school purposes. Perhaps it would be well to consider a more equitable form of taxation for school purposes. Along with equitability, the income tax possesses the characteristic of being less easily shifted than other types of levies. This is because it is direct in nature.

Flexibility of the tax burden, moving up or down with changes in income, is another of the important attributes of a progressive income tax. The burden of payments presumably levels out, insofar as the tax bite declines with a drop in income, and increases with an in-

crease in income or ability to pay.

Finally, it can be argued that more progressive types of taxes should be used by the state in order to counterbalance the extreme regressivity in our state and local tax systems. Regressive taxation means that those with lower incomes pay a larger percentage of their incomes in taxes than those with larger incomes. Progressive taxation results when an increased percentage of a person's income goes for taxes as his income increases. Well over 90% of the total state tax collections in South Dakota comes from regressive taxation.

Disadvantages of a State Income Tax

Revenue Not Constant. While the flexibility of a state income tax can be pointed to as an advantage to the individual, it can also be considered a disadvantage in terms of the stability of tax revenue. In a state which is subject to wide variation in income one might also expect wide variations in income tax revenue. A state in this position relying heavily on a state income tax may have to build reserves in periods of relatively high income and possibly have deficit spending in periods of low income to provide adequately for tax-sponsored services.

The variation in total personal income in South Dakota during the past 10 years has been from a low of about \$690 million in 1949 to a high of \$1,075 million in 1957. These fluctuations stem primarily from the fluctuations occurring in farm proprietors' income which

averaged approximately 28% of the state's total personal income for the 10-year period. The high was 44.8% in 1948 and the low was 17.1% in 1955 (see chart).

While the farm proprietors' sector of total personal income in South Dakota has portrayed wide variations, one cannot assume that income tax revenue from that sector would follow an identical pattern. To a large extent the fluctuation in farm proprietors' income presented in the chart is caused by the changes occurring in value of farm inventories. These changes in value of farm inventories are taken into account by farmers who file their income tax on an accrual basis and to this extent farm tax revenue would follow the variation presented in the chart. However, the largest percentage of farmers report on a cash rather than an accrual basis, and filing on a cash basis does not take into account changes in farm inventory. Thus, the actual tax receipts from farm proprietors, and consequently total tax receipts, would not be expected to follow a pattern quite as erratic as that portrayed in the chart.

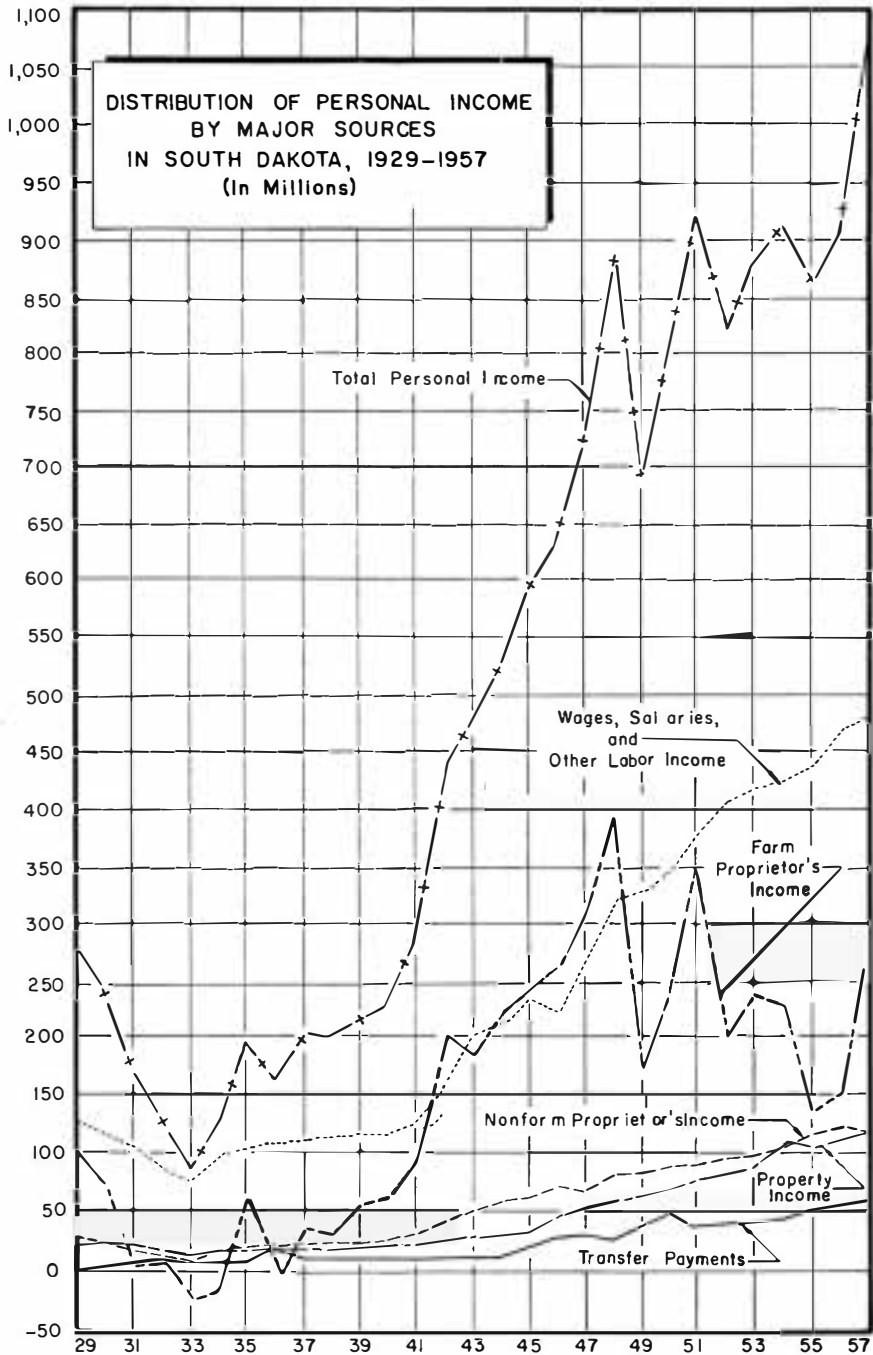
In an almost completely agricultural economy where virtually all of the agricultural production is for the farmer's own consumption, an income tax would not be a satisfactory tax. This, however, is not the type of economy we have in South Dakota. The percent of total personal income going to the agricultural sector appears to be declining and much of the production on farms is marketed commercially.

Also, fewer farmers are sharing the income going to agriculture.

Need Accurate Records. Successful administration of the income tax requires a fairly accurate system of records. In the early days before federal income tax legislation, the type of records kept by many would have been quite a handicap. While inadequate records are still an important item, this problem is probably not as serious today because good records are necessary in order to stay in business as well as to meet the requirements imposed by other taxing authorities.

Evasion. The problem of evasion and avoidance is often mentioned in connection with an income tax. Part of this problem may be overcome by urging that better records be kept. This may not result in a sizable increase in tax payments, however, as studies show that while there is underreporting of income because of poor records, there is also underreporting of expenses. Requiring a broader base upon which to levy the tax as well as establishing rates which are considered reasonable by taxpayers, should also encourage more accurate reporting. Students of public finance usually suggest that a state income tax be broad in its coverage, requiring a maximum number of taxpayers to contribute to the state's services. Also, the rates should be only mildly progressive to avoid the risk of stifling initiative by becoming confiscatory.

Irregular Incomes Taxed More. A taxpayer with irregular income also has to pay more under a pro-



Source: U. S. Department of Commerce, "Survey of Current Business."

gressive income tax than other individuals who have the same amount of income but receive it in more uniform annual amounts. Some of this inequity can be reduced by allowing the individuals with irregular incomes to carry backward and/or forward a portion of their income.

Other Considerations of a State Income Tax

Not to be overlooked in a state tax picture is the impact of the federal taxes on the taxpayers of a state. While the state tax system as such may be highly regressive, when the federal tax is included the regressivity is certainly reduced and the total tax system might even be slightly progressive.

The argument is sometimes raised that the cost of administering a state income tax is so high that much of the revenue is lost in the process of collecting it. Statistics available on costs of administering a state income tax suggest that this contention is perhaps exaggerated. North Dakota estimates, for instance, that its cost of collecting each income tax dollar in 1957 was less than 3 cents. Iowa estimated the ratio of costs to collection at 1.01% for the same year.⁶ It is to be expected that the cost of collecting each dollar of income tax would be higher in sparsely settled states where agriculture is a major industry or where average income is relatively low.

Efficiency, convenience, and better compliance in paying income taxes have all resulted by using the withholding features. This device has much merit for a state tax pro-

gram as well as for the federal tax system.

One other requisite that a tax should have is that the revenue from the tax should be large enough to make it worth while. In terms of the income tax, the amount of revenue is based on the structure of the tax as well as the income position of those to be taxed. If there are few or no allowances for exemptions and a high rate, one could expect the tax to be more lucrative. Not only should the taxing of individuals be studied, the taxing of corporations should not be overlooked.

The impact of a state income tax on the individual should not be measured assuming that his total tax burden would increase by the amount of the state income tax. The state income tax payment, as with other state taxes, is a deductible item in federal income tax schedules. However, one would have to itemize deductions rather than take the standard 10% deduction to take advantage of this offsetting feature. A state income tax would probably make it worth while for many to itemize their deductions.

An indication of how productive a state income tax in South Dakota might be and the impact of such a tax on various income levels can be observed from the alternative tax programs that have been prepared.

State Income Tax Alternatives That Might Be Used

The following material suggests several alternatives that might be

⁶Obtained by personal inquiry from the state offices of the Tax Commissioners in North Dakota and Iowa.

followed, or parts of which may be followed, if a state income tax is desired. These alternative techniques would have the advantages of approaching the objectives of (1) taxing in accordance with ability to pay, (2) taxing all people who realize a net income so that all in this group would contribute to the benefits they receive, and (3) using a tax that is not easily shifted. Not only are these techniques designed to meet the objectives of taxing in relation to ability to pay as well as taxing in accordance with benefits received, the systems outlined could also return a substantial amount of revenue and could be easily administered by using data already required for the federal tax returns.

Tax rates could either be applied to that figure which is referred to as the "adjusted gross income" or the figure allowing personal exemptions and standard deductions called "taxable income" on the federal forms. If no allowances are made for personal exemptions and standard deductions, the lower income recipients would have to bear a larger portion of the income tax burden than if such exemptions were allowed. Not allowing the exemptions would, on the other hand, spread the burden over more of those who are receiving benefits from tax expenditures.

For illustrative purposes, several types of state income tax systems which could be used in South Dakota are presented. One alternative would be to apply selected tax rates to what is termed the adjusted

gross income figures as calculated under the federal income tax requirements. The adjusted gross income figures take into account business expenses. They include income made up of what is received from wages and salaries, dividends, interest, combined net profit or net loss from business or profession, combined net profit or loss from partnership, combined net gain and net loss from sale of capital assets, and combined net income and net loss from rents and royalties. The adjusted gross income is thus the net income before any allowances have been made for personal exemptions and other exclusions such as for sick pay, the \$50 dividend exclusions, and the retirement income provisions.

An estimate of the amount of revenue that could be raised using either proportional rates or progressive rates multiplied by the adjusted gross income figures follows.

The adjusted gross income for South Dakota reported by the Internal Revenue Department for individuals for 1956 was \$671,728,000. Assuming first that a proportional tax were applied to this adjusted gross income figure, the amount of revenue that could be raised at a 2% rate would be about \$13.4 million. This percentage rate could, of course, be adjusted in accordance with the amount of revenue desired. Under this system all who realize a net income would be subject to the 2% levy. While the low income taxpayers would not pay as much in number of dollars as the higher income groups, the

burden of paying this smaller amount in taxes may be as great or greater than for the higher income recipient.

This system approaches the objective of taxing in accordance with benefits received but falls short of the objective of equalizing tax burdens or taxing on the basis of ability to pay.

A second alternative might be to set up progressive tax rates applicable to various levels of incomes. Here again the degree of progression could depend upon the amount of money that was being sought as well as the desire to equalize the burden of tax payments.

An indication as to how such a tax plan might work and how much might be raised from levies which progress from one-half of 1% for incomes under \$1,000 to 9% for that portion of one's income over \$100,000 can be seen from the following schedule and table. First, the schedule shows how an individual can compute his taxes and indicates

what tax rates might apply to various income amounts. Following the schedule is a table prepared to show how much individuals might expect to pay with various incomes at the assumed tax rates. It can be seen that applying these rates to the income in South Dakota in this manner should raise more than \$10 million.

The individual tax payments could be computed in accordance with the Individual Tax Schedule (see table 1).

It should be noted in the schedule that the percentage rates only apply to that amount of income over a given figure and do not apply to one's entire income except for those reporting less than \$1,000. The tax rate for the first \$1,000 earned would be less than for the second, the rate for the second, would be less than for the third, and so forth. Thus the effective tax rates—the percent of the average income in each group payable in taxes—are much less progressive than the percentage figures shown

Table 1. An Example of Individual Tax Schedule That Might Be Used in South Dakota

If adjusted gross income is:		The tax is:	
Not over \$1,000	.....	0.5%	of adjusted gross income
Over \$ 1,000 but not over \$ 2,000	.....	\$ 5 plus 1.0%	of excess over \$ 1,000
Over \$ 2,000 but not over \$ 3,000	.....	\$ 15 plus 1.5%	of excess over \$ 2,000
Over \$ 3,000 but not over \$ 4,000	.....	\$ 30 plus 2.0%	of excess over \$ 3,000
Over \$ 4,000 but not over \$ 5,000	.....	\$ 50 plus 2.5%	of excess over \$ 4,000
Over \$ 5,000 but not over \$ 10,000	.....	\$ 75 plus 3.0%	of excess over \$ 5,000
Over \$10,000 but not over \$ 15,000	.....	\$ 225 plus 4.0%	of excess over \$ 10,000
Over \$15,000 but not over \$ 20,000	.....	\$ 425 plus 5.0%	of excess over \$ 15,000
Over \$20,000 but not over \$ 25,000	.....	\$ 675 plus 6.0%	of excess over \$ 20,000
Over \$25,000 but not over \$ 50,000	.....	\$ 975 plus 7.0%	of excess over \$ 25,000
Over \$50,000 but not over \$100,000	.....	\$2,725 plus 8.0%	of excess over \$ 50,000
Over \$100,000	.....	\$6,725 plus 9.0%	of excess over \$100,000

above. Among other things, the effective tax rates shown in the following table range from .005 for income under \$1,000 to .068 for net incomes over \$100,000 (see table 2).

This type of tax schedule meets the objective of compelling all net income recipients to pay for the benefits they receive from tax expenditures. At the same time it introduces some progressivity into the system whereby the burden is more equally shared by all taxpayers than is the case when a proportional tax is applied.

To achieve more equity and ease

of collecting taxes, using a state income tax of the type prepared in table 2, it is perhaps desirable to consider exempting the first \$5, \$10, or \$15 of tax liability. Exempting the first \$15 would, for instance, exclude those with incomes under \$2,000 where the tax burden would probably be the greatest, it would eliminate the cost of processing more than 80,000 returns, which is more than one-third of the total, and would reduce the total revenue by less than \$600,000. Exempting the first \$5 would eliminate the processing of over 40,000 returns, the cost of which may amount to a

Table 2. An Example of the Tax Revenue That Might be Raised from a State Income Tax and a Calculation of the Tax Cost Per Taxpayer by Income Classes in South Dakota (1956)*

Taxable Income	Number of Returns 1956	Adjusted Gross Income 1956 (000)	Average Taxpayer's Income	Estimated Tax Per Taxpayer†	Total Tax in Each Group	Effective Tax Rates
No						
Adjusted Gross	8,483	\$ 10,794‡	\$	\$	\$	
Under \$1,000	41,768	24,883	595.74	2.98	124,415	.005
\$1,000-\$2,000	44,328	66,196	1,493.32	9.93	440,319	.007
\$2,000-\$3,000	38,583	95,820	2,483.48	22.25	858,557	.009
\$3,000-\$4,000	30,907	107,712	3,485.04	39.70	1,227,033	.011
\$4,000-\$5,000	28,189	126,366	4,482.81	62.07	1,749,697	.014
\$5,000-\$10,000	28,528	183,227	6,422.71	117.68	3,357,212	.018
\$10,000-\$15,000	2,094	24,953	11,916.43	301.66	631,670	.025
\$15,000-\$20,000	823	13,939	16,936.82	521.84	429,475	.031
\$20,000-\$25,000	598	13,520	22,608.70	831.52	497,250	.037
\$25,000-\$50,000	636	21,283	33,463.84	1,567.47	996,910	.047
\$50,000-\$100,000	68	4,347	63,926.48	3,839.12	261,060	.060
Over \$100,000	3	306	102,000.00	6,905.00	20,715	.068
Total	225,008	\$671,758	\$ 2,985.48	\$ 29.78§	\$10,594,313	

*Data compiled from a sample taken from individual tax returns, U. S. Treasury Department, Internal Revenue Service "Individual Income Tax Returns for 1956," p. 61.

†Computed on the basis of the assumed rates in the foregoing schedule.

‡Adjusted Gross Deficit.

§Average tax based on the average income of taxpayers. The average tax bill based on numbers of tax payers is \$47.08.

large portion of the revenue which could be expected to be collected from this group (\$125,000).

A third alternative would be to remit to the state a percentage of that amount which is paid in federal taxes. In 1956, for instance, the Internal Revenue Service reported that \$59,847,000 was paid in federal income taxes by individuals in South Dakota. From this it would appear that a 10% rate would return between \$5 and \$6 million. It would probably be closer to the 5 million figure as the state taxes would be deductible from the federal returns, reducing the taxable income. Thus the federal tax payments would be somewhat less than they would be without a state income tax. It would probably take a 20% rate to raise \$10 million from individuals in South Dakota.

A minor adjustment would have to be made if federal income tax data were used as a basis for a state income tax. Interest received from obligations of the United States or its possessions is not taxable by the states even though it is taxable under the federal income tax law. Therefore such interest would have to be deducted from the adjusted gross income figures of the federal

return if such figures are to be used.

A final consideration for increasing tax revenues in South Dakota would be to tax corporations. It is, however, difficult to determine how much could be raised in this state from such a levy because of incomplete data. Many domestic corporations file in other states, and several foreign corporations file in South Dakota. A very rough approximation is that corporations taxed in South Dakota in a manner similar to that practiced in several other states might be expected to yield at least \$1 million. This \$1 million figure is arrived at in the following way. The Internal Revenue Service reported a net income for corporations of \$24,401,000 for South Dakota for 1956. Assuming a 5% corporation tax rate for South Dakota, a rate which exists in several other states, it could be expected that over a million dollars would be raised.

The procedures outlined are only suggestions and are very flexible. Exemptions and/or deductions may be provided or changes in rates may be made. It is hoped that the procedures can be of some benefit if and when a state income tax is considered.